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8 *Attorney for Creditor*
9 BAOHUA ZHENG

10 **UNITED STATES BANKRUPTCY COURT**
11 **CENTRAL DISTRICT OF CALIFORNIA**

12 In re:

13 **REX SPIRITS, INC.,**

14 Debtor.

CASE NO. 6:13-BK-24063-SC

CHAPTER 11

**MOTION TO CONVERT CASE, OR, IN
THE ALTERNATIVE, FOR
APPOINTMENT OF CHAPTER 11
TRUSTEE; MEMORANDUM OF POINTS
AND AUTHORITIES IN SUPPORT
THEREOF; DECLARATION OF JOHN M.
KALAJIAN IN SUPPORT THEREOF**

DATE: DECEMBER 10, 2013

TIME: 1:30 PM

PLACE: VIDEO HEARING ROOM 126
3420 TWELFTH STREET
RIVERSIDE, CA 92501

PLACE: COURTROOM 5C
411 WEST FOURTH STREET
SANTA ANA, CA 92701

*(HEARINGS TO BE HELD CONCURRENTLY
AT BOTH LOCATIONS)*

25 **MOTION TO CONVERT CASE, OR, IN THE ALTERNATIVE, FOR APPOINTMENT OF**
26 **CHAPTER 11 TRUSTEE; MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT**
THEREOF; DECLARATION OF JOHN M. KALAJIAN IN SUPPORT THEREOF

1 **TO: THE HONORABLE SCOTT C. CLARKSON, UNITED STATES**
2 **BANKRUPTCY JUDGE; DEBTOR REX SPIRITS, INC., AND ITS COUNSEL OF**
3 **RECORD; THE UNITED STATES TRUSTEE; AND ALL OTHER PARTIES IN**
4 **INTEREST:**

5
6 BAOHUA ZHENG, a creditor herein, will and does hereby move this Court for entry of
7 an Order, pursuant to Section 1112(b) of the United States Bankruptcy Code (11 U.S.C. §§101 *et*
8 *seq.*) dismissing or converting the Chapter 11 case of Rex Spirits, Inc. or, in the alternative,
9 pursuant to Section 1104 of the Bankruptcy Code, appointing a Chapter 11 trustee to manage the
10 Debtor's affairs, and respectfully represents as follows:

11 **BACKGROUND**

- 12
13 1. On August 19, 2013, ("Petition Date"), Rex Spirits, Inc., the Debtor-in-Possession herein
14 ("Debtor") filed a petition for relief under Chapter 11 of the United States Bankruptcy
15 Code.
16
17 2. The Debtor is currently operating as Debtor-in-Possession in accordance with the
18 provisions of 11 U.S.C. §§1101 *et seq.*
19
20 3. Mr. Baohua Zheng ("Zheng") is a creditor of the within estate pursuant to a Loan
21 Agreement and Promissory Note ("Note") in the original amount of \$1,000,000. See,
22 Declaration of John M. Kalajian ("Kalajian Declaration") filed and served herewith, at
23 Paragraph 2. A true and correct copy of the Note is attached to the Kalajian Declaration
24 as Exhibit "A" thereto.
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MOTION TO CONVERT CASE, OR, IN THE ALTERNATIVE, FOR APPOINTMENT OF
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1 4. Zheng's loan to Debtor of \$1 million was made for the express, written purpose of
2 assisting Debtor's business. Pursuant to Paragraph 4 of the Note, entitled "Use of
3 Proceeds", it was agreed that:

4 Borrower shall use the proceeds of the loan for the purpose of
5 funding the products development, products manufacturing,
6 human resources, and marketing purposes of the Borrower, not
7 any other purposes. Otherwise, it is considered breach of the agreement
8 and the principal amount is due immediately. [Emphasis added]

9 See, Kalajian Declaration at Paragraph 3.

10 5. Rex acknowledged in its verified answers to written interrogatories in the State Court
11 Case that it had repaid Zheng only \$300,000 of the \$100,000,000 loan. There is presently
12 due and outstanding under the terms of the Note, Exhibit "A" hereto, the sum of
13 \$700,000.00, together with statutory interest at the rate of ten percent (10%) per annum
14 and attorney's fees, for a total claim estimated to be in excess of \$800,000, now due and
15 payable. See, Kalajian Declaration at Paragraph 4.

16
17 6. Zheng's claim is at least partially secured pursuant to a Right to Attach Order and Writ of
18 Attachment obtained and levied prior to the Petition Date. The value of the assets secured
19 by the Writ of Attachment is presently unknown. See, Kalajian Declaration at Paragraph
20 5.

21
22 7. The Right to Attach Order and Writ of Attachment were obtained in an action
23 commenced by Zheng against Debtor in the Los Angeles Superior Court, Case No. KC
24 065753.

- 1 8. Debtor has commenced an adversary proceeding related to the within Chapter 11 case
2 attempting, *inter alia*, to avoid certain alleged payments as preferential transfers in
3 accordance with 11 U.S.C. §§547(b) and 550. Zheng denies that the alleged payments
4 were preferences. See, Kalajian Declaration at Paragraph 6.
- 5 9. Zheng is informed and believes and based thereon alleges that Debtor has engaged in
6 self-dealing, gross mismanagement, and misappropriation of funds, as more fully
7 discussed herein below, both before and after the Petition Date, and that such acts have
8 damaged and continue to damage Zheng irreparably, warranting the relief sought herein.
9 See, Kalajian Declaration at Paragraph 7.
- 10 10. The following allegations, made on information and belief, form the factual basis for the
11 within motion.
- 12 11. A Profit and Loss Statement dated December 12, 2012, and authored by Desi Ortiz (the
13 brother of Sal Ortiz, Debtor's president), a true and correct copy of which is attached to
14 the Kalajian Declaration as Exhibit "B" thereto, reflects, *inter alia*, excessive business
15 expenses and multiple personal expenditures unrelated to Debtor's business, in breach of
16 the terms and conditions of the Note, and, perhaps of greater significance, indicative of
17 the Debtor's proclivity towards mismanagement and self-dealing, which are among the
18 grounds for the within motion. See, Kalajian Declaration at Paragraph 8. As indicated on
19 the Profit and Loss Statement ("P&L"), these expenditures are as follows:
20
21 a. Payroll of \$126,609.23 (P&L page 14), plus an additional \$53,171.39 for "sub-
22 contractors" (P&L page 18), including a \$10,000 expense for a "marketing team"
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as well as a \$20,000 payment to Desi Ortiz in January 2013, essentially depleting Debtor's bank account;

- b. Travel, including multiple junkets to Las Vegas \$30,454.66 (P&L page 21) including \$5,341.28 for limousine travel, \$502.68 for "WSWA Investor Hotel Suite at Caesar's Palace, and a \$1,058.72 expense for "Vegas Business Trip Room Charge";
- c. Extravagant dinners including \$586.05 at the Palms (P&L page 8); \$1,473.92 and \$1,155.88 at Caesar's Palace hotel rooms (P&L page 8);
- d. Daily lunches and dinners of \$15,426.91 (P&L page 10);
- e. Extraordinary gas expenses of \$4605.30 (P&L page 7);
- f. Cash expenditures with no breakdown or receipts including \$800 "Cash to Sal Ortiz for Business Trip Per Diem" (P&L page 9); and
- g. Miscellaneous suspect expenditures including \$1134 at Paris Box Office for "Entertainment for Kevin, Bin, Sal and Desi" (P&L page 8).

12. To fully appreciate the degree to which these actions violate the express terms of the Note, as well as highlight the lack of integrity of the Debtor, it should be noted that during the time period in which these expenditures were made, the Debtor had gross income of approximately \$60,000 which, after the cost of goods sold, netted revenues of only \$39,653.16 against total expenditures of \$428,310.33. Debtor's "business" activities and expenses thus accounted for the loss of approximately 40% of Zheng's \$1 million investment in less than a year. Not only does this conduct suggest gross mismanagement but, when weighed against expenditures such as a more than \$5000 suite at Caesar's

1 Palace, renders Debtor's integrity suspect and supports the relief requested herein. See,
2 Kalajian Declaration at Paragraph 9.

3
4 13. A consent judgment in a trademark infringement case against Rex requires Debtor to
5 stop selling product by February 2014 and to assign trademarks to a company called
6 School of Design, which was the plaintiff in that case. The consent judgment further
7 limits the Debtor's ability to market its remaining inventory of King Rex Vodka
8 worldwide for one year, except in the States of Louisiana, Mississippi and Alabama.
9 Accordingly, the continued viability of the Debtor's operations is doubtful and renders
10 this Chapter 11 destined for conversion and liquidation. See, Kalajian Declaration at
11 Paragraph 10. A true and correct copy of the Consent Judgment is attached to the Request
12 for Judicial Notice filed and served herewith as Exhibit "A" thereto.

13
14 14. It appears that on or about July 26, 2013, **less than one month before the Petition Date**,
15 Sal Ortiz, the president of Debtor, removed 710 cases of vodka from a warehouse called
16 "Biagi Brothers." There does not appear to be any reference to these cases in Debtor's
17 prepetition QuickBooks, in the Debtor's Statement of Financial Affairs at questions 10 or
18 elsewhere. Even selling the cases at \$120 per case, (which is just about break even after
19 the costs of manufacture and shipping), this represents more than \$85,000 in missing
20 assets. See, Kalajian Declaration at Paragraph 11. A copy of the records from Biagi Bros
21 showing the cases were released to Ortiz is attached to the Kalajian Declaration as
22 Exhibit "C" thereto.
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1 15. It appears that the Debtor may have certain undisclosed assets to wit, 4050 bottles of
2 vodka located in South Carolina and valued at approximately \$488,000, and 1422 bottles
3 of vodka located in China and valued at approximately \$32,000, neither of which appear
4 to be listed as assets on the Debtor's schedules filed herein. Sec, Kalajian Declaration at
5 Paragraph 12.
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8 16. The Debtor's Schedules, Statement of Financial Affairs, and the sole Monthly Operating
9 Report filed to date, measured against the unfortunate business record discussed above,
10 suggest the inevitability of liquidation with little or no viable hope of reorganization.
11 Allowing the Debtor to retain control of the few assets in its possession while it spirals
12 into liquidation would serve no rehabilitative purpose and would put all creditors,
13 including Zheng, at risk of irreparable harm. Given the demonstrable lack of success
14 since the inception of the Debtor's business, together with the complete disregard for the
15 safekeeping of the investment proceeds to which it was entrusted, continuing
16 unsupervised in a Chapter 11 proceeding would cause more harm than good.
17 Accordingly, dismissal or conversion of the case to Chapter 7, is necessary and
18 appropriate pursuant to Section 1112(b) of the Bankruptcy Code, or, in the
19 alternative, pursuant to Section 1104, appointing a Trustee to manage the Debtor's affairs.
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MEMORANDUM OF POINTS AND AUTHORITIES

Dismissal or Conversion Pursuant to Section 1112(b)

1. Section 1112(b) enumerates several examples of what constitutes “cause” to dismiss or convert a case, including where there is (i) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation, (ii) inability to effectuate a plan, or (iii) unreasonable delay by the debtor that is prejudicial to creditors. *See* 11 U.S.C. §1112(b)(1), 1112(b)(2), 1112(b)(3).

2. A finding of “cause” is not limited to the grounds stated in Section 1112(b). *See* 11 U.S.C. §102(3) (in construing the Bankruptcy Code, the terms “includes” and “including” are not limiting).

Appointment of a Trustee Pursuant to Section 1104

3. Section 1104 of the Bankruptcy Court provides in pertinent part:

At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest and after notice and a hearing, the court *shall* order the appointment of a trustee –

- (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause . . . ;
- (2) if such appointment is in the interest of creditors, any equity security holders, and other interests of the estate . . . ; or

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- 1 (3) if grounds exist to convert or dismiss the case under Section 1112, but the
2 court determines that the appointment of a trustee of examiner is in the best
3 interests of creditors and the estate.

4 11 U.S.C. § 1104(a) (emphasis added).

5 4. In accordance with the express language of Section 1104(a)(1), courts have
6 consistently held that “the appointment of a trustee is mandatory upon a determination of cause.”
7 *In re Marvel Entertainment Group, Inc.* 140 F. 3d 463, 472 (3d Cir. 1998).

8 5. Under Section 1104(a)(2), among the factors considered are (i) the trustworthiness
9 of the debtor; (ii) the debtor-in-possession’s past and present performance and prospects for the
10 debtor’s rehabilitations; (iii) the confidence – or lack thereof – of the business community and of
11 creditors in current management; and (iv) the benefits derived by the appointment of a trustee,
12 balanced against the cost of the appointment. *In re Adelphia Communications Corp.* 336 B. R.
13 610, 658 (Bank, S.D.N.Y.2006)
14

15 6. Applying these factors to the case, it is clear that ample grounds exist for either
16 conversion or appointment of a Chapter 11 Trustee. The Debtor has demonstrated, at a minimum,
17 gross mismanagement leading up to the Petition Date. Moreover, the mysterious disappearance
18 of more than \$80,000 worth of inventory less than a month before the Petition date suggests
19 fraud, as does the Debtor’s failure to list certain assets as described above. Additionally, Zheng
20 will present evidence, if needed, that neither Debtor nor Debtor’s product have any credibility in
21 the business community.
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23 7. Simply stated, the Debtor’s manifest bad conduct has created a powerful basis to
24 conclude that it cannot be relied on or trusted to properly discharge the duties of a Debtor-in-
25 Possession in an honest and proper manner. Given the compelling evidence supporting this

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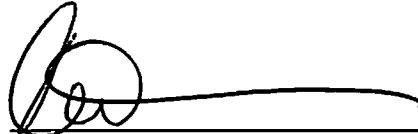
1 conclusion and the precedent cited, Zheng submits that under the mandatory language of Section
2 1104 this Court, if it does not otherwise dismiss or convert the Debtor's cases, must appoint a
3 Trustee to manage the Debtors' affairs.

4 8. No prior request has been made for the relief requested herein.

5 **WHEREFORE**, Zheng requests entry of an order (i) pursuant to Section 1112(b) of the
6 Bankruptcy Code dismissing or converting the Debtor' case or (ii), in the alternative, pursuant to
7 Section 1104 of the Bankruptcy Code, appointing a Trustee to manage the Debtor's affairs and
8 (iii) providing such other relief as is just.

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10 Dated: October 30, 2012

11 **LAW OFFICES OF**
12 **KENNETH CHARLES GREENE**

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14 

15 By: Kenneth C. Greene

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19 **DECLARATION OF JOHN M. KALAJIAN IN SUPPORT OF**
20 **MOTION TO CONVERT CASE, OR, IN THE ALTERNATIVE,**
21 **FOR APPOINTMENT OF CHAPTER 11 TRUSTEE**

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24 I, John M. Kalajian, hereby declare:

25 1. I am the attorney for creditor Boahua Zheng in the state court action

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1 entitled Boahua Zheng v. Rex Spirits, Inc., ("Rex" or "Debtor") Los Angeles County Superior
2 Court Case Number KC KC065753 (hereafter "State Court Case"). Trial was set in the State
3 Court Case for August 26, 2013. Substantial discovery had been completed and the deposition
4 of the Person Most Knowledgeable had been scheduled after multiple delays requested by
5 Debtor. I have personal knowledge of the facts set forth herein, except as to those which
6 are alleged on information and belief. If called as a witness, I could and would testify
7 competently to the following allegations.
8

9 2. Boahua Zheng ("Zheng") is a creditor of the within estate pursuant to a Loan
10 Agreement and Promissory Note ("Note") in the original amount of \$1,000,000. A true and
11 correct copy of the Note is attached hereto as Exhibit "A". In the State Court Case, Rex
12 acknowledged the genuineness of the loan documents in Requests for Admission and responded
13 with verified answers to written interrogatories that Rex received a \$1,000,000 loan from Zheng.
14

15
16 2. The loan documents provide pursuant to Paragraph 4 of the Note, that:

17
18 Borrower shall use the proceeds of the loan for the purpose
19 of funding the products development, products manufacturing,
20 human resources, and marketing purposes of the Borrower,
21 not any other purposes. Otherwise, it is considered breach of the
agreement and the principal amount is due immediately.
[Emphasis added]

22 4. Rex acknowledged in its verified answers to written interrogatories in the State
23 Court Case that it had repaid Zheng only \$300,000 of the \$1,000,000 loan. There is presently
24 due and outstanding under the terms of the Note, Exhibit "A" hereto, the sum of \$700,000.00,
25

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1 together with statutory interest at the rate of ten percent (10%) per annum and attorney's fees, for
2 a total claim estimated to be in excess of \$800,000 total, now due and payable.

3
4 5. In the State Court Case, Zheng applied for and was issued a Right to Order and Writ
5 of Attachment prior to the petition date.

6
7
8 6. I am informed and believe that the Rex has commenced an adversary proceeding
9 related to the within Chapter 11 case attempting, *inter alia*, to avoid certain alleged payments as
10 preferential transfers in accordance with 11 U.S.C. §§547(b) and 550. Based upon all of the
11 corporate records, records of the minutes of the meeting of directors, minutes and other
12 documents obtained from Rex during discovery of the State Court Case, no records have been
13 produced by Rex that suggest that Boahua Zheng was an officer, or director of Rex nor is there
14 any evidence that Zheng controlled or operated Rex in any way. According to verified responses
15 to special interrogatories, there was only one face to face meeting between Sal Ortiz and Zheng
16 which took place in December, 2011 and no further direct contact between the Zheng and Ortiz
17 at any time thereafter. Zheng denies that the \$300,000 payment issued to Zheng on the due date
18 of the loan is January, 2013 was a "preferential" payment under the bankruptcy code inasmuch
19 as the payment was made approximately six months before this within bankruptcy proceeding
20 was filed and Zheng was not an insider under any definition of that term.

21
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23 7. Based upon my review of the written discovery responses and records and documents
24 produced in the State Court Case, it is undisputed that Rex did not actually have a vodka product
25 to actually sell, nor did any production of vodka products take place until approximately
26

1 November, 2011. Based upon the documents produced by Rex in the State Court Case, I
2 am informed and believe and based thereon allege that Rex, and, in particular, Rex's Chief
3 Operating Officer/President/Owner (as self-described on certain of his correspondence) has
4 engaged in self-dealing, gross mismanagement, and misappropriation of funds for the personal
5 use of himself, friends and his family members both before and after the Petition Date, and that
6 such acts have damaged and continue to damage Zheng and other creditor of the estate
7 irreparably.
8

9
10 8. A Profit and Loss Statement dated December 12, 2012, was produced in verified
11 responses to discovery in the State Court Case and authored by Desi Ortiz (the brother of Sal
12 Ortiz, Rex's president)), a true and correct copy of which is attached hereto as Exhibit "B"
13 reflects, *inter alia*, excessive business expenses and multiple personal expenditures unrelated to
14 Rex's business, in breach of the terms and conditions of the Note, and, perhaps of greater
15 significance, indicative of the Debtor's proclivity towards mismanagement and self-dealing,
16 which are among the grounds for the within motion. As indicated on the Profit and Loss
17 Statement ("P&L"), these expenditures are as follows:
18

- 19 a. Payroll of \$126,609.23 (P&L page 14), plus an additional
20 \$53,171.39 for "sub-contractors" (P&L page 18), including a
21 \$10,000 expense for a "marketing team", and a \$20,000
22 payment to Desi Ortiz in January 2013 (essentially depleting
23 Debtor's bank account balances at Chino Business Bank);
24 b. Travel, including \$30,454.66 for multiple junkets to Las
25 Vegas (P&L page 21), \$5,341.28 for limousine travel, \$502.68
26 for "WSWA Investor Hotel Suite at Caesar's Palace, and

1 \$1,058.72 for "Vegas Business Trip Room Charge"; These
2 trips appear to have occurred in April, May, June, July,
3 September and October of 2011, all during a time when Debtor
4 had no product for sale and when there could be no legitimate
5 marketing or business related component for traveling to Las
6 Vegas.

7 c. Extravagant dinners including \$586.05 at the Palms (P&L
8 page 8), \$1,473.92 and \$1,155.88 at Caesar's Palace hotel
9 rooms (P&L page 8);

10 d. Daily lunches and dinners of \$15,426.91 (P&L page 10);

11 e. Extraordinary gas expenses of \$4605.30 (note that there are
12 days when the car is used three to four times per day (P&L
13 page 7) ;

14 f. Cash expenditures with no breakdown or receipts including
15 \$800 for "Cash to Sal Ortiz for Business Trip Per Diem" (P&L
16 page 9); and

17 g. Miscellaneous suspect expenditures including \$1134 at
18 Paris Box Office for "Entertainment for Kevin, Bin, Sal and
19 Desi" (P&L page 8).

20 9. To fully appreciate the degree to which these actions violate the express terms of the
21 Note, as well as highlight the Debtors' lack of integrity, it should be noted that during the time
22 period in which these expenditures were made, the Debtor had gross income of approximately
23 \$60,000 which, after the cost of goods sold, netted revenues of only \$39,653.16 against total
24 expenditures of \$428,310.33. Debtor's "business" activities thus accounted for the loss of
25 approximately 40% of my \$1 million investment in less than a year. Not only does this conduct
26 suggest gross mismanagement but, when weighed against expenditures such as a \$5000 suite at

1 Caesar's Palace, such conduct renders Debtor's integrity suspect and supports the relief
2 requested herein.

3
4 10. Shortly after Rex first marketed the vodka product, it was sued and a Consent
5 Judgment was entered in a trademark infringement case against Rex Spirits, Inc. The Consent
6 Judgment requires Debtor to stop selling product by February 2014 and to assign trademarks to a
7 company called School of Design, which was the Plaintiff in that action. The Consent Judgment
8 further limits the Debtor's ability to market its remaining inventory of King Rex Vodka
9 worldwide for one year, except for the States of Louisiana, Mississippi and Alabama.
10

11
12 11. I obtained documents pursuant to a subpoena served on Biagi Bros., a warehouse that
13 stocked debtor's vodka products, showing that on July 26, 2013, less than month before the
14 Petition Date, Sal Ortiz, the president of Debtor, removed 710 cases of vodka from Biagi Bros.
15 warehouse. There does not appear to be any reference to this transfer in Debtor's prepetition
16 QuickBooks reports, its Statement of Financial Affairs (at question 10) or elsewhere. At a value
17 of \$200 per case, this represents more than \$140,000 in missing assets. A copy of the records
18 from Biagi Bros showing the cases were released to Ortiz is attached hereto as Exhibit "C".
19

20
21 12. I am informed and believe and based thereon allege that the Debtor may have certain
22 undisclosed assets to wit, 4050 bottles of vodka located in South Carolina and valued at
23 approximately \$488,000, and 1422 bottles of vodka located in China and valued at
24 approximately \$32,000, neither of which appear to be listed as assets on the Debtor's schedules
25 filed herein.
26

1 13. I declare under penalty of perjury that the foregoing is true and correct.

2 Executed this 28th day of October, 2013 at Simi Valley, CA.

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5 JOHN M. KALAJIAN
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NOTICE OF MOTION TO CONVERT CASE, OR, IN THE ALTERNATIVE, FOR APPOINTMENT OF CHAPTER 11 TRUSTEE,
MEMORANDUM OF POINTS AND AUTHORITIES ISO MOTION, DECLARATION OF JOHN M. KALAJIAN IN SUPPORT
THEREOF